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RURAL TIMES 1

The Real Exchange Rate

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Many farmers, miners and manufacturers want the government to reduce interest rates and thereby allow the A$ to fall below US$0.70, below Y100 or whatever. Then, they believe, the Wool Corporation stocks will fall, wheat and mineral profits will rise, imported cars and clothing will be replaced by domestic manufactures and the current account will not be so awful.

As Australia slips into an interest-rate-induced recession, interest rates will no doubt fall. Then, when foreign investors can no longer obtain in Australia the highest rates to be found in any politically-safe, western democracy, some of them will remove their capital. Then the Australian dollar will fall. But this is not the panacea some imagine it to be.

It is not a panacea for two reasons: first, because devaluation increases the Australian dollar cost of servicing our foreign debt; and, second, because, if nothing else is done, the beneficial effects of devaluation will not last long.

Other things do not remain equal following devaluation. Farmers, for instance, find that their chemicals and machinery are more expensive, while car manufacturers pay more for their imported components and so on. Further, since devaluation allows producers of traded goods (both exporters and import competers) to raise their prices, the nappies, motor cars and other goods that compete with imports are more expensive in domestic markets, and so are the wheat and meat which have their prices set in export markets.

If that were the end of the story there would be a continuing wealth transfer from people who must pay more for their goods to producers of traded goods such as farmers and car makers. The advantaged producers would find it profitable to increase their output and invest more in their industries and their additional output would, it is true, help to balance the current account. But the gain would have been paid for by a drop in real consumption---that is, in the current standard of living. In other words, there would have been a transfer from this generation to future generations to whom we would be leaving less debt.

If, on the other hand, the price rises were to be reflected in higher wages and other personal incomes so that the living standard did not fall, there would have been nothing gained from devaluation. What, after all, happened to previous massive devaluations? It is not so many years ago that the A$ was worth US$1.00 and Y200. Yet at US$0.78 and Y110 that rate the current account is even more unsustainable and our foreign debt grows.

The truth is that a devaluation can restore competitiveness only when it becomes the means by which incomes are reduced. That is, when it tricks us into living more nearly within our means. In the short run, devaluations tend to do that, but not for long unless they are also accompanied by a sense of crisis---e.g. by massive unemployment or something else we could do without.

There is more to becoming competitive and to coping with the current account problem than devaluation. Lower real wages, whether achieved by devaluation or by any other means, tend to improve competitiveness. But again things don't always remain equal: there comes a point where the best and brightest workers migrate. Loss of these people does not help unit costs---ask any Third World country.

The only acceptable, long-run solution to declining competitiveness is to raise productivity. Since reducing investment certainly will not raise productivity the only aternative to accumulating foreign debt is to rely less on foreign savings by saving more ourselves. If we save more, we will have less to spend on consumables---including imported consumables.

The solutions to our problems are simple enough in principle. To raise productivity the government must deregulate and privatise. To encourage savings it must get rid of inflation and place less reliance on incomes taxation. These are the long-term solutions.

In the meantime, the coming devaluation, which will unfortunately tend to increase inflation, must be prevented from feeding through into wages and other costs for as long as that is possible.

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